

Attachment B

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Section 251 Unbundling)	
Obligations of Incumbent Local Exchange)	CC Docket No. 01-338
Carriers)	
)	
Implementation of the Local Competition)	
Provisions of the Telecommunications Act)	CC Docket No. 96-98
of 1996)	
)	
Deployment of Wireline Services Offering)	CC Docket No. 98-147
Advanced Telecommunications)	
Capability)	

**DECLARATION OF DANIEL KELLEY
On Behalf of WorldCom, Inc.**

TABLE OF CONTENTS

I. ALL FORMS OF COMPETITION PROVIDE CONSUMER BENEFITS	3
II. UNBUNDLING WILL NOT REDUCE INCENTIVES TO INVEST	11
III. UNBUNDLING WILL NOT DETER INNOVATION	19
IV. ILECS WILL BE COMPENSATED FOR LEGITIMATE COSTS OF UNBUNDLING	21
V. REGULATION IS A NECESSARY PREREQUISITE TO COMPETITION	24
A. Regulation Has Been Used to Facilitate the Introduction of Competition	25
B. Competition Is Necessary for Deregulation.....	28
C. CLECs Have Not Been Given Special Advantages.....	30
VI. LOCAL SERVICE PRICING DOES NOT AFFECT AN IMPAIRMENT ANALYSIS	32

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Section 251 Unbundling)	
Obligations of Incumbent Local Exchange)	CC Docket No. 01-338
Carriers)	
)	
Implementation of the Local Competition)	
Provisions of the Telecommunications Act)	CC Docket No. 96-98
of 1996)	
)	
Deployment of Wireline Services Offering)	CC Docket No. 98-147
Advanced Telecommunications)	
Capability)	

**DECLARATION OF DANIEL KELLEY
On Behalf of WorldCom, Inc.**

1. My name is Daniel Kelley. Along with my colleagues Richard Chandler and David Nugent, I prepared a Report filed on behalf of WorldCom, Inc. (“WorldCom”) in the initial round of comments in this proceeding.¹ I have also filed Declarations in the Commission’s closely related proceedings dealing with Broadband Dominance and the framework for regulating incumbent local exchange carrier (“ILEC”) Broadband Internet services.² In this Declaration I address economic arguments made by several parties in their initial comments in this proceeding.

¹ Richard Chandler, A. Daniel Kelley and David M. Nugent, “The Technology and Economics Of Cross-Platform Competition In Local Telecommunications Markets,” HAI Consulting, Inc., April 4, 2002 (“HAI Report”), Attachment A to Comments of WorldCom, Inc., CC Docket No. 01-338, filed April 5, 2002.

² *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337, Notice of Proposed Rulemaking, 16 FCC Rcd 22745 (2002) (“*Broadband Dominance Proceeding*”), Comments of

2. In Section I, I address the claims that only facilities-based competition provides significant consumer benefits. In fact, intramodal competition is important in its own right and also serves to ensure competition for downstream services. Section II demonstrates that unbundling will not have a negative effect on either ILEC or competitive local exchange carrier (“CLEC”) investment. Section III dispels ILEC allegations that unbundling deters innovation. Innovation is stimulated by the presence of more providers, not fewer. Access to unbundled network elements (“UNEs”) provides an opportunity for a greater number of CLECs to enter local service markets. Section IV addresses ILEC claims that the cost of unbundling is excessive. In Section V, I explain how interim, pro-competitive regulations imposed during a number of previous Federal Communications Commission (“FCC” or “Commission”) proceedings have resulted in vibrant, competitive telecommunications service and equipment markets that have benefited consumers in many ways. Finally, in Section VI, I explain how both Congress, via the Telecommunications Act of 1996,³ and the Commission, through its universal service funding mechanisms and recent access pricing decisions, have addressed existing cross-subsidies. I also show that despite the views of some, including that of the U.S.

WorldCom, Inc., March 1, 2002, Declaration of Daniel Kelley, Attachment A, March 1, 2002 (“Kelley Broadband Dominance Declaration”); *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, CC Docket No. 02-33, Notice of Proposed Rulemaking, 17 FCC Rcd 3019 (2002), Joint Comments of WorldCom, Inc., The Competitive Telecommunications Association and The Association of Local Telecommunications Services, May 3, 2002, Attachment 1, Declaration of Daniel Kelley, May 2, 2002. I will incorporate portions of my Declarations in these other Dockets to the extent the arguments are relevant here.

³ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151 *et seq.* (1996) (“1996 Act” or “Act”).

Court of Appeals for the District of Columbia, residential local service customers are not the beneficiaries of significant subsidies.

3. The criticisms of basing UNE prices on economic cost, which are raised by several ILEC economists, are addressed in the Report of Professor Janusz Ordover.⁴

I. ALL FORMS OF COMPETITION PROVIDE CONSUMER BENEFITS

4. The ILECs and their economists extol the virtues of facilities competition. However, there is no law of economics that says that facilities competition is superior to any other form. For example, Dr. Howard Shelanski on behalf of BellSouth claims that the benefits from UNE-based competition are limited to the small amount of value added associated with retailing local service.⁵ In most markets in the economy, firms that own upstream production facilities are *not* integrated into wholesale distribution and/or retail operations. Independent wholesalers and retailers add significant value by identifying and meeting consumer needs, thereby freeing the manufacturer to specialize in what it does best. Often these firms, including UNE-based CLECs, invest substantial amounts in facilities needed to perform their functions. Even firms that decide to do nothing more than resell ILEC retail offerings must invest in or lease facilities needed to contact customers and provide customer service.

5. While UNE-based local exchange competition provides important consumer benefits in its own right, the ancillary benefits in markets related to the local exchange are

⁴ Janusz A. Ordover, "Pricing Network Elements at TELRIC: A Necessary Prerequisite for Local Competition," ("Ordover Report"), Attachment D to Reply Comments of WorldCom, Inc., CC Docket No. 01-338, filed July 17, 2002.

potentially more significant. Unbundling will ensure that competition for downstream unregulated services remains robust. The HAI Report documented the lack of local competition and the probability that ILECs will remain dominant in the provision of local facilities for many years to come. This means that the ILECs will effectively control consumer access to downstream services that rely on local telephone connections.

6. Providing customers with a choice of retail suppliers of local telephone service through loop unbundling or UNE-platform (“UNE-P”) will help preserve competition for downstream services such as Internet access, long distance and vertical services (*e.g.*, voice mail). ILECs have an incentive to use their control over the upstream facilities to compete unfairly in vertically related markets.⁶ This is particularly important in a world in which services are increasingly bundled.

7. As evidenced by its filing in opposition to the proposed Decree in *U.S. v. Microsoft*, SBC Communications recognizes that where network effects contribute to market power, the resulting monopolist has the incentive and ability to restrict competition:

Unchecked, Microsoft will favor its own and its partners’ services, exclude competitors’ products and services from access to consumers, and degrade its rivals’ services and raise their costs (by charging a toll, imposing a fee for listing as an available service or creating an interoperability obstacle). Because potential customers will have to pass through a Microsoft operating system . . . Microsoft will retain the ability to exclude or marginalize all manner of telephone services, messaging products, video or music offerings, Internet services, and other ‘utilities’

⁵ Declaration of Howard A. Shelanski, April 4, 2002 (“Shelanski Declaration”), p. 8, attached to Comments of BellSouth Corporation, CC Docket No. 01-338, filed April 8, 2002.

⁶ See Janusz Ordover and Garth Saloner, “Predation, Monopolization, and Antitrust,” Volume 1, Chapter 9, *Handbook of Industrial Organization*. Richard Schmalensee and Robert D. Willig (ed.), Elsevier Science Pub. Co., New York 1989.

of modern life. In this way, the Microsoft monopoly threatens to destroy the vast panoply of consumer choice among the myriad sources that create and distribute communications and entertainment products and services.⁷

If Microsoft can engage in this behavior using the software at the edges of the telecommunications network, then SBC and its fellow ILEC monopolists can do the same within the network that connects the computers together.

8. It is also quite significant that the ability to add value to unbundled network elements can serve as a platform for innovation. Digital subscriber line (“DSL”) services were introduced to a significant portion of the population not through ILEC retail offerings, but through the offerings of the data local exchange carriers (“DLECs”). Collocation and access to unbundled loops allowed the DLECs to invest in equipment needed to provide broadband access. Absent collocation and unbundling, this would not have happened. As monopolists, the ILECs actually have incentives to restrict valuable uses of their networks.

9. Finally, the availability of UNEs reduces barriers to facilities-based entry. Resale and UNE competition are stepping-stones to facilities competition. Resellers have been a fixture in the long distance market since competition was introduced. Some of these resellers have remained in the resale business while others have gone on to become facilities competitors. Similarly, the availability of UNEs reduces barriers to local entry. The ability to acquire a customer base through UNE-P, for example, will justify

⁷ *United States v. Microsoft Corporation*, U.S. District Court for the District of Columbia, Civil Action No. 98-1233 (CKK), Comments of SBC Communications, Inc. On the Proposed Final Judgment, January 28, 2002 (SBC Comments, *U.S. v. Microsoft*), pp. 2-3.

investment in switching and transport. In the current financial climate, having a revenue base is particularly important to raising the capital needed to invest in facilities.⁸

10. Some ILECs, in the original round of comments in this proceeding, allege that the stepping stone concept is incorrect: that when CLECs have access to UNEs, particularly UNE-P, they have no intention of ever undertaking facilities construction. To support this allegation the so-called UNE Fact Report is cited.⁹ The UNE Fact Report in turn references the declaration of Vijetha Huffman on behalf of WorldCom in a previous Commission proceeding.¹⁰ In her declaration, Ms. Huffman, states, in part:

UNE-P . . . is the only service-entry vehicle that WorldCom uses to offer local residential service, and it is the only service-delivery option that WorldCom currently views as even potentially viable.¹¹

11. Even taken out of context, as the ILECs have done, Ms. Huffman's statement does not support the allegation that once CLECs are granted access to UNEs, they intend never to migrate off those UNEs by constructing facilities. Ms. Huffman stated that

⁸ Organization for Economic Co-Operation and Development, "Developments in Local Loop Unbundling," Directorate for Science, Technology and Industry, Committee for Information, Computer and Communications Policy, DSTI/ICCP/TISP(2002)5, May 2, 2002, para. 50.

⁹ See "UNE Fact Report 2002," Prepared for and Submitted as an attachment to the Comments of BellSouth, SBC, Qwest, and Verizon, CC Docket 01-338, April 2002.

¹⁰ *Id.*, pp. II-17 – II-18, n.56.

¹¹ Declaration of Vijetha Huffman, attached to Comments of WorldCom, Inc., *Application of Verizon New Jersey, Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc. and Verizon Select Services Inc. for Authorization To Provide In-Region, InterLATA Services in New Jersey*, CC Docket No. 01-347, filed Jan. 14, 2002, para. 5.

UNE-P is the only option currently viewed as viable. When other options (*i.e.*, facilities construction), become viable, competitors are likely to make the necessary investments.¹²

12. The fact is, CLECs prefer to construct their own facilities; no reasonable business wants to be dependent on its major, and much larger, competitor to supply it with the essential facilities it needs to serve its customers. If UNE rates are truly set at TELRIC, then when the economics tell a CLEC it can justify its own facilities, the CLEC will build them if it can, if for no other reason than it does not want to be dependent on its competitor. History demonstrates that the transaction costs of dealing with the ILECs are substantial. As Professor Willig notes, when CLECs build their own facilities, they “avoid the transactional, monitoring, litigation, and related costs of leasing from the ILEC.”¹³ And if the economics cannot justify facilities construction, the CLEC will not build its own facilities, as it should not, because under such circumstance facilities construction will not result in consumer benefit (or CLEC benefit either). UNEs provide a way for local service competition to exist until the economics permit facilities construction. And if the economics never justify facilities construction, UNEs still provide an important consumer benefit by providing an avenue for CLECs participation in local service markets and giving consumers a choice of local service providers.

13. Thus the major effect of withdrawing UNEs will not be to “encourage” facilities construction. The result will be reduced consumer benefits from retail

¹² In the same footnote that references Ms. Huffman’s declaration, the UNE Fact Report also cites the supplemental declaration of Mr. Michael Lieberman in CC Docket 01-324 (Feb. 8, 2002) on behalf of AT&T as further “evidence” that the CLECs have no intention of converting from UNE-P to facilities competition. The portion of Mr. Lieberman’s declaration that is cited by the UNE Fact Report is also taken out of context.

competition and higher entry barriers into the facilities market. Moreover, it is impossible to encourage facilities construction where it is simply uneconomic. As the accompanying Declaration of Dr. Mark T. Bryant demonstrates,¹⁴ the significant economies of scale and density that the Commission noted in the *Local Competition Order*¹⁵ have not magically disappeared with the passage of time. This issue is also discussed in the HAI Report and in the Declaration of Dr. Richard Clarke for AT&T. For example, Clarke finds that

. . . the cost disadvantages faced by an entrant relative to the incumbent are very severe. Even assuming impossibly nimble and effective entry plans, the average cost disadvantage faced by a 10% to 20% market share entrant ranges from 35% to 250%. And even if an entrant can capture 30% of the market, its cost disadvantage remains in the 20% to 60% range.¹⁶

Building loops to serve the vast majority of customers is simply not viable. As long as substantial scale economies are present, unbundling will be necessary to bring at least some of the benefits of competition to consumers.

14. Dr. John Haring and Mr. Harry Shooshan argue that the experience in Great Britain proves that the lack of unbundling will not deter facilities competition. They cite a line share of almost 20 percent for NTL and Telewest, and attribute it to an emphasis on

¹³ See Declaration of Robert D. Willig, Attachment F to AT&T Comments (“Willig Declaration”), para. 18.

¹⁴ Declaration of Mark T. Bryant, (“Bryant Declaration”), Attachment A to Reply Comments of WorldCom, Inc., CC Docket No. 01-338, filed July 17, 2002.

¹⁵ *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) (“*Local Competition Order*”), para. 11.

¹⁶ Declaration of Richard N. Clarke On Behalf of AT&T, April 4, 2002 (“Clarke Declaration”), pp. 3-4, Attachment B to Comments of AT&T, CC Docket 01-338, filed April 5, 2002.

facilities competition by regulators.¹⁷ The British example, however, is not particularly relevant to the situation in the United States. Cable telephone companies in Britain had the advantage of a green field start when they built their networks in the 1990s. Prior to that time there was little cable available in Britain. As a result, the cable companies were able to put in copper wire pairs at the same time they installed the coaxial cable necessary for video services. In effect they were able to construct low cost copper overbuilds. Thus they could provide telephony services for a much lower incremental cost than could cable companies in the United States, which have to upgrade their coaxial cable networks to make them two-way compatible.

15. Cable telephony competition in Britain was also advantaged by the fact that the British Telecom (“BT”) rate structure included high per message charges.¹⁸ Finally, at the time cable systems in Great Britain were being constructed, BT was a recently privatized firm still suffering from the legacy of government ownership, which is typically even less efficient than private monopolies. What is surprising then is not that the share of lines held by competitors in Great Britain is so high, but that it is so low.

16. Haring and Shooshan admit that despite the glowing picture of facilities competition they paint, the regulator in Great Britain has recently ordered loop unbundling.¹⁹ They attribute this to leverage exercised by competitors over regulators – a form of regulatory capture evidently induced by “alienation of affection” and some

¹⁷ John Haring and Harry M. Shooshan, “Reorienting Regulation: Toward a More Facilities-Friendly Local Competition Policy,” Strategic Policy Research, April 3, 2002 (Haring-Shooshan), pp. 3-4, Attachment A to Comments of Qwest Communications International, Inc., filed April 12, 2002.

¹⁸ This fact helps to explain the higher minute share for competitors in Great Britain. *See id.*

unspecified pressure from the U.S. In fact, what inspired loop unbundling in Britain was that Oftel, the British regulator, conducted an exhaustive proceeding, concluding that BT faces limited competition.²⁰ Oftel's findings merit quoting at length:

. . . the focus has been on the delivery of services over BT's copper local loop, upgraded to provide higher bandwidth capability. The rationale behind this approach has been that:

- BT's local network is ubiquitous;
- BT has a very strong position in the local access market, with limited direct competition;
- BT is likely to remain the primary supplier of local access in the near future.

Oftel expects that other technologies also have the capability in the medium term to provide widespread access to higher bandwidth – cable, satellite, and broadband fixed wireless in particular. These technologies and others may in time provide a real alternative to higher bandwidth delivered over the local loop.

But in the near future Oftel believes that the local loop, upgraded using technologies such as DSL, offers the greatest potential to deliver higher bandwidth access to the mass market. It is for this reason that access to customers through the local loop is the focus of this document. When other technologies, such as those described above, develop to the extent that there is effective competition in the provision of higher bandwidth access Oftel can withdraw from regulation.²¹

At the end of the day, then, the experience in Great Britain does not support the argument made by Haring and Shooshan. It was not industrial policy in favor of facilities construction by competitors, but simple marketplace economics that led to limited cable

¹⁹ *Id.*, p. 3, n.2.

²⁰ A summary of the Oftel unbundling process can be found at http://www.oftel.gov.uk/publications/local_loop/llufacts/llufacts0501.htm.

²¹ Oftel, "Access to Bandwidth: Delivering Competition for the Information Age," November 1999 (paragraph numbers omitted).

competition after markets were opened to competition. The regulator in Great Britain now recognizes that limited competition from cable companies is not enough, and is taking steps to unbundle the loop.²²

17. It is curious that the ILECs are the largest cheerleaders for facilities competition. By making their networks available on reasonable terms to CLECs, it would seem that they could retain better control over their core monopoly. Their reluctance to do so suggests that they recognize: a) that unbundling reduces barriers to facilities entry and enhances downstream competition; and b) facilities competition is quite difficult, and therefore not a tremendous short run threat to their revenue streams.

II. UNBUNDLING WILL NOT REDUCE INCENTIVES TO INVEST

18. ILECs and their economists argue that unbundling requirements reduce both ILEC and CLEC incentives to invest. These points were addressed in detail in the HAI Report.²³ In short, withdrawal or overpricing of UNEs will not encourage the CLECs to build facilities that they would not build otherwise. Where facilities construction is viable, unbundling will not deter it. Indeed, as the Supreme Court recently noted, the CLECs have in fact invested a substantial amount of money since the 1996 Act passed.²⁴ But if it is not economic to enter by constructing facilities, then the CLECs will not enter.

<http://www.oftel.gov.uk/publications/1999/competition/a2b1199.htm#Summary> (last viewed May 24, 2002).

²² Haring and Shooshan argue that the limited number of unbundled loops actually being sold in Great Britain somehow discredit the policy (*see* Haring-Shooshan, p. 3, n.2). First, the policy was implemented much later than U.S. policy. Second, the absence of switching and transport unbundling in Great Britain reduces the usefulness of loop unbundling.

²³ HAI Report, pp. 88-97.

²⁴ *Verizon Communications Inc. v. FCC*, 122 S.Ct. 1646, 1651 (2002).

19. One of the benefits of total element long-range incremental cost (“TELRIC”) pricing is to give entrants the information they need to make correct build or lease decisions. As I stated previously, all else being equal, new entrants would prefer to have their own facilities because they then will avoid transactions costs and not be subject to service degradation from their key supplier, who is also their key competitor. As the HAI Report shows, cable and wireless competition are being held back by business and technical considerations. The availability or non-availability of cost-based UNEs will have only a marginal impact on their decision to invest.

20. As noted above, denying CLECs the opportunity to use elements of the ILEC network only reduces the incentive and ability of CLECs to invest in their own facilities. Where leased loops can be used to serve business customers, the CLECs may be able to justify further investments in switching and transport facilities. If the ILECs begin providing CLECs with the necessary ability to make “hot cuts,” the switching and transport investment necessary to support unbundled loops may become viable.

21. Z-Tel provided a study showing that investment in switching facilities is positively correlated with the availability of switching UNEs.²⁵ The intuition behind this result is that having alternative modes of entry enhances a CLEC business plan. That is, the fixed cost of entry can be recovered more readily if several entry modes are available.²⁶

²⁵ Z-Tel, “Does Unbundling Really Discourage Facilities-Based Entry? *An Econometric Examination of the Unbundled Switching Restriction*, Z-Tel Public Policy Paper No. 4, Z-Tel Communications, Inc., February 2002.

²⁶ See Willig Declaration, para. 48 for a discussion of the fixed costs of entry.

22. It must also be noted that unbundled loops allowed DLECs to make the major investments necessary to bring broadband over copper to consumers. The DLEC business plan is to collocate their broadband equipment in ILEC wire centers in order to reach their own customers, but the availability of unbundled loops was a prerequisite to their investment in DSLAMs and other broadband equipment.

23. Unbundling will not deter intermodal competition as the High Tech Broadband Coalition (“HTBC”) and the Progress & Freedom Foundation (“PFF”) claim.²⁷ Cable companies that are not investing in cable telephony are not entering local service markets with UNEs instead. These companies have competing uses for their cable capacity, and they are waiting for the next generation of technology to resolve technical issues related to cable telephony before making further commitments to local markets.²⁸ There is no indication that AT&T, which is proceeding with cable telephony, has scaled back cable telephony plans due to the availability of UNEs. As shown in the HAI Report, wireless companies lack the capacity to become significant wireline competitors. The availability of UNEs does not affect their investment decisions.

24. But even if it did turn out that the availability of UNEs at economic cost means that the marginal cable or wireless investment is not made, that result is consistent with economic efficiency. If cable companies invest money in telephony when it is more efficient to provide the same service over existing wireline facilities, then resources have

²⁷ See Comments of High Tech Broadband Coalition, CC Docket 01-338, April 5, 2002, p. 26, and Comments Of The Progress & Freedom Foundation, CC Docket 01-338, April 5, 2002, p. 31.

²⁸ See HAI Report, pp. 24-30.

been misallocated. Forcing uneconomic investment by closing ILEC networks is not good economic policy.

25. ILECs allege that their incentives to invest are reduced because selling to CLECs exposes them to stranded plant when the CLECs do build their own facilities, or if the CLECs do not use the capacity created for them. The ILECs and their economists argue that this is a particularly severe problem in the case of broadband, where demand and technological uncertainty are greater. Eliminating unbundling requirements is not a solution to these alleged problems. The TELRIC methodology, as implemented in both the FCC Synthesis Model²⁹ and the HAI Model,³⁰ is sufficiently robust to accommodate risk. As Professor Ordover shows, the TELRIC methodology works to generate correct price signals even when there is rapid technological change.³¹ The TELRIC methodology incorporates the effect of technological change on economic costs through inputs used to estimate depreciation and the cost of capital. The process created by the Act gives the ILECs ample opportunity to make their case for the proper input levels to state regulators.

26. Haring and Rohlfs attempt to show that UNE requirements make broadband investment unprofitable for ILECs.³² In their example an ILEC has a one-third chance of

²⁹ See <http://www.fcc.gov/ccb/apb/hcpm>. The FCC's cost proxy model was originally called the Hybrid Proxy Cost Model ("HCPM"), but is now also referred to as the HCPM/HAI Synthesis Cost Proxy Model, or simply "FCC Synthesis Model."

³⁰ HAI local exchange proxy cost model, "HAI Model Release 5.0a," filed with the FCC on February 16, 1998 ("HAI Model"). Release 5.0a is available from the International Transcription Service, Washington, D.C.

³¹ Ordover Report, *supra*. note 4.

³² See John Haring and Jeffrey H. Rohlfs, "The Disincentives for Broadband Deployment Afforded By the FCC's Unbundling Policies," April 4, 2002 (Haring-

losing money on broadband service and a two-thirds chance of making money. Given the parameters selected by Haring and Rohlfs, the ILEC will make the investment as long as there is no intramodal competition. If unbundling is required, a CLEC will purchase UNEs in the second scenario (see below) and compete away the profits from the broadband investment, thus making the investment unprofitable for the ILEC.

27. There are several problems with their analysis. First, Haring and Rohlfs implicitly assume that alternative broadband platforms will not evolve to compete away the profits. That is, contrary to claims by their clients, there will be no effective intermodal competition. If the ILEC believes there will be intermodal competition, then given the parameters they select, the investment is dead in the water, with or without CLECs.

28. Second, in Haring and Rohlfs' second scenario, the CLEC makes money even after the broadband profits are competed away because it earns substantial positive profits on narrowband services provided over the loop. This is a feature of the Strategic Policy Research ("SPR") Telcomp© Model that Haring and Rohlfs use. The Telcomp Model found that "a UNE-based CLEC could operate profitably (rate of return of 39 percent) supplying local services to the mass market."³³ The high profitability of leasing loops shown by the Telcomp Model will surely come as a surprise to the former employees of the dozens of CLECs that have failed since the Model was released in 1999. If the CLEC is making small, or non-existent, margins on the narrowband services, then its combined narrowband/broadband profits will be small as well. On the other hand, if the CLEC can

Rohlfs), pp. 14-16, attached to Comments of High Tech Broadband Coalition, CC Docket 01-338, filed April 5, 2002.

make these margins, then it must follow that the ILEC can also make economic profits on the investment, as long as TELRIC represents economic cost.

29. Third, Haring and Rohlfs assume that the ILEC incurs substantial expenses for providing DSL and for making loops broadband ready. They evidently assume these costs are not recovered in the price of UNEs. In any event, the cost of adding broadband capability to a DSL ready loop is the same for both the ILEC and CLECs. Moreover, the McKinsey cost numbers used by Haring and Rohlfs (\$47 per customer per month pre-tax)³⁴ are highly suspect. HAI's ADSL Model, submitted in several state arbitration proceedings, shows that DSL costs tend to be in the vicinity of \$10 per month per line, including ATM backhaul to some centralized ATM switch where a reseller might interconnect. Furthermore, existing retail ADSL offerings from Qwest (without bundled ISP service) are priced at \$22 per month.³⁵ In many parts of Qwest's service area (such as Denver), there is no competition from cable companies or even wireless broadband service providers. There cannot be any real justification for Qwest to sell this service at this small fraction of the "costs" supposedly calculated by McKinsey.³⁶

³³ *Id.* p. 18

³⁴ *Id.* p. 17.

³⁵ See "Qwest DSL 256" service, \$21.95 per month, ISP subscription additional, http://www.uswest.com/pcat/for_home/product/1,1354,537_1_11,00.html (viewed May 25, 2002).

³⁶ Applying a monthly cost factor of 0.025 for ADSL equipment suggests that McKinsey assumes an investment per ADSL subscriber of well over \$2000. This is difficult to support. One can buy, in single quantities, an ADSL modem (new) for under \$100 off the Web. The DSLAM contains functions complementary to those in the CPE modem, plus some additional functions that are shared among many (possibly a few hundred) users. There is no way the network investment per subscriber would approach McKinsey's apparent estimate, even when one considers transport and ATM switching and routing devices. The notion that the copper loop would be "upgraded" to support 1.5 Mbps transmission speeds makes no technical sense, if "upgraded" means installing new

30. Haring and Rohlfs use their numerical example in an attempt to explain why ILECs are scaling back their DSL deployment. Other hypotheses are equally compelling. Douglas Shapiro of Banc of America Securities believes that “lower-than-expected” penetration of ILECs in the broadband Internet access business is not due to regulation but “due to DSL economics, an inflexible shareholder base and a spotty record pursuing growth initiatives.”³⁷ Shapiro goes on to argue that the pressure to aggressively pursue DSL revenue streams is reduced because:

... the ILECs are arguably more secure in their local franchise monopolies today than they have been in a decade. That’s because the presumed threats to their local businesses have eroded rapidly over the past several months – long distance providers are struggling with a deteriorating business and the CLECs are obviously a much less significant competitive threat.³⁸

Shapiro also points out that the ILECs have in fact deployed DSL extensively and that extensive further deployment may simply not be economic. As he notes, “removing in-region long distance data carriage prohibitions or unbundling requirements will do little to change population density.”³⁹ In other words, the ILECs may have already made the investments that it is economic to make.

copper facilities, as it seems to imply. In a few cases, loading coils might need to be removed and some bridged tap eliminated. These are one-time costs that should not be capitalized. Even if they were, a \$10 monthly recurring charge is hard to envision. Furthermore, the implication that “upgrading” is required for copper loops longer than 12,000 feet is wrong. ADSL is specified for copper loops up to 18,000 feet in length and can be extended beyond that. See Telcordia Notes on the Network (SR-2275, Issue 4, Oct. 2000, p 12-50).

³⁷ Douglas S. Shapiro, “Broadband Brief: What Does Telecom Deregulation Mean for Cable?” Equity Research, Banc of America Securities, March 13, 2002, p. 4. <http://www.bofasecurities.com/featuredresearch/content/docs/031502.pdf> (viewed May 25, 2002).

³⁸ *Id.* p. 5.

³⁹ *Id.*, p. 3.

Granting their deregulation wish list will not incent them to make further investments. As their merger condition compliance record demonstrates, the ILECs will not do what is not in their self-interest, unless regulators enforce the rules.

31. Another factor is that profitable broadband applications simply have not evolved as expected. The ILECs would rather milk the profits from T1s at the high end, and sell highly profitable narrowband access in the form of second lines at the low end.⁴⁰ When it becomes clear that broadband demand justifies further investment, the ILECs will make them.

32. Haring and Shooshan provide another interesting hypothesis concerning ILEC complaints about regulation and their threats to withhold broadband investment unless they receive special treatment (*i.e.*, deregulation that is not warranted by the degree of competition). They write that:

The risk for regulators of the inability to say “enough is enough” is that competitors will always seek more – and more will never be enough. An even greater danger arises when the regulators perceive “a stake” in the success of certain competitors. Once that line is crossed, it is easy for competitors to “threaten” to fail if more favors are not bestowed on them, thereby making regulators look bad.⁴¹

Haring and Shooshan wrote these words in the context of CLECs threatening to fail if ILECs refuse to unbundle their networks or provide network elements at reasonable prices. If that was the CLEC strategy, it appears that their commitment was credible

⁴⁰ *Broadband Dominance Proceeding*, Reply Declaration of Daniel Kelley, April 22, 2002 (“Kelley Broadband Dominance Reply”), p. 9-10, Attachment A to Reply Comments of WorldCom, Inc., filed April 22, 2002.

⁴¹ Haring-Shooshan, p. 15, citing John Haring, “The FCC, The OCCs and the Exploitation of Affection,” FCC OPP Working Paper No. 17 (June 1985).

because many of them did indeed fail. But the same argument applies to ILECs' demanding to be freed from the requirements of the 1996 Act, and from the Commission's rules implementing the Act, before they make the broadband investments that regulators have made their top priority.⁴² The FCC should not allow the ILECs to exploit its affection for broadband investment. Recent history shows that carrots should not be handed out before the donkey moves.

33. Finally, it must be noted that the ILECs have for many years been claiming that they are subject to competitive risk, yet they have continued to invest in their networks, and indeed accelerated those investments after passage of the Act.⁴³ Building modern, up-to-date networks is likely the best way to handle such risk. The ILECs in this proceeding also conveniently ignore the substantial benefits conferred upon them by the 1996 Act. In exchange for opening their networks, they are being allowed to compete in interLATA markets. Surely this benefit must be weighed against the risk associated with unbundling, but none of the ILEC economists mentions this fact.

III. UNBUNDLING WILL NOT DETER INNOVATION

34. The ILECs and their economists argue that unbundling deters innovation. In general, the ILEC economists make abstract arguments about the benefits of innovation without looking fully into the nature of the technology and without considering the economic and market conditions that will best facilitate innovation. For example, Kahn

⁴² See opening remarks of Michael K. Powell, Chairman, FCC, press conference October 23, 2001, "Digital Broadband Migration" Part II ("[T]he widespread deployment of broadband infrastructure has become the central communications policy objective today.").

⁴³ HAI Report pp. 96-97.

and Tardiff worry about applying regulation to new services while failing to recognize that the broadband technologies they are referring to are hardly new.⁴⁴ The empirical evidence shows that monopolists, and particularly telecommunications monopolists, have a generally poor history of performance in the area of innovation.

35. Unbundling will create parallel paths of innovation by allowing multiple firms to use the monopoly network resource as the foundation for new products and services. The importance of unbundling to innovation was eloquently explained by SBC Communications in its opposition to the proposed decree in *U.S. v. Microsoft*. In complaining about the Decree's failure to insure interoperability, SBC points out that

In the longer term, as competitive choices in these markets are diminished, Microsoft will be able to unilaterally control the pace of innovation. Currently, many different companies are working to innovate and develop different product functions and niche uses. SBC can take advantage of specialized innovations that are essential to supporting or improving its operations. In the world created by the proposed settlement, however, Microsoft will be the sole arbiter of what areas, products or uses should or should not be explored for technological advancement. Microsoft would be free to stifle innovation in a particular area that may be crucial to developing a product or a service which competes with Microsoft.⁴⁵

SBC then went on to cite government economic expert Paul Romer, who points out that, "... Microsoft harmed the innovative process because it limited competition, and competitive markets are, on balance, the best mechanism for guiding technology down a path that benefits consumers."⁴⁶

36. In an article surveying technological change in telecommunications, Shelanski comes to the same conclusion:

⁴⁴ Declaration of Alfred E. Kahn and Timothy J. Tardiff, December 18, 2001 ("Kahn-Tardiff Declaration").

⁴⁵ SBC Comments, *U.S. v. Microsoft*, p. 127.

This positive correlation between competition and adoption of new technology suggests that regulators and enforcement officials should be wary of claims that, by adhering to policies designed to preserve competition, they will impede firms from deploying innovations or bringing new services to consumers.⁴⁷

37. Finally, and related to the previous point, innovation in this industry does not have to come from the monopolists. Equipment vendors are responsible for most of the research and development expenditures in telecommunications. Assuring multiple platforms for innovation, even if these platforms are built on ILEC facilities, will encourage more R&D efforts from vendors.

IV. ILECS WILL BE COMPENSATED FOR LEGITIMATE COSTS OF UNBUNDLING

38. The ILECs argue that unbundling is expensive. However, modern networks are built in a modular fashion. The individual building blocks are connected to one another with interfaces, and those interfaces can typically be easily opened to allow interconnection of a competitor's facilities.⁴⁸ To the extent there are costs of opening the interfaces, they are legitimately included in the TELRIC of an unbundled network element. However, it makes eminently good public policy sense to recover certain one time or set-up costs from the broad group of consumers for the services that will be provided using the facilities.

⁴⁶ *Ibid.*, p. 128.

⁴⁷ Howard A. Shelanski, "Competition and Deployment of New Technology in U.S. Telecommunications," The University of Chicago Legal Forum, 2000 U Chi Legal F 85 (2000).

⁴⁸ *Local Competition Order*, paras. 198-199. *See also* Hatfield Associates Inc., "New Local Exchange Technology: Preserving the Bottleneck or Providing Competitive Alternatives?", April 6, 1992 (describing trends towards open interfaces in the local telephone network).

39. In any event, it is useful to examine unbundling for broadband further. In the case of all copper facilities, the claim of significant costs is simply not viable. A loop used for a competitor's DSL service is the same as a loop used for voice service. The question of the costs of conditioning a loop for DSL, for example to remove loading coils or bridge taps, has been investigated and resolved by the states.

40. Qwest argues that it has incurred substantial expenses to provide sub-loop unbundling that are now wasted because CLECs are not using the facilities. One response to such a complaint is that the DLECs have not expanded due to their financial difficulties, which DLECs allege are due to ILEC delays, poor performance and price squeezes.⁴⁹ It would hardly seem right to complain that firms that have been driven out of business due to lack of cooperation by the ILECs have failed to pay for facilities that they would have used but for the actions of the ILECs.

41. Dr. Shelanski argues that Project Pronto has been delayed due to the expense associated with complying with unbundling requirements.⁵⁰ There are several responses. First, as described in the accompanying Declaration of Tom Stumbaugh, David Reilly, and William R. Drake, SBC's initial plans for Project Pronto provided for unbundling

⁴⁹ See Shawn Young, "Covad, One of Last DSL Competitors, Blames Troubles on Bell Tactics," The Wall Street Journal, August 9, 2001, p. B1. See also, Yale M. Braunstein, "Market Power and Price Increases in the DSL Market," School of Information Management and Systems, University of California, Berkeley, July 2001, "[t]he practices of the ILECs restrict the ability of other carriers to enter and compete. These practices have included maintaining unreasonable delays in the provisioning of local lines and collocation facilities and charging ISPs a wholesale price for DSL that is unjustifiably high."

⁵⁰ Dr. Shelanski's Declaration, read carefully, does not conclude that unbundling is bad *per se*, or that competitors would not be impaired if they did not have access to loops.

and SBC's subsequent refusal to unbundle is based on business considerations.⁵¹ Second, Shelanski's numbers are suspect. No evidence is provided to support his allegation that hundreds of millions of dollars are necessary to comply with unbundling requirements. And in fact, in state regulatory proceedings SBC has been unable to demonstrate costs in the amounts they allege.⁵² Third, my understanding is that WorldCom needs bit rate access to connect with the DSLAMs in their collocation space or enhanced extended links ("EELs"), neither of which requires extraordinary engineering expense to accomplish. In limited situations, access to DLC facilities in the loop would make technical and economic sense, and WorldCom would like the ability to interconnect on that basis on reasonable terms. But massive, system-wide investments are not necessary to accommodate these requests, and my understanding is that WorldCom would pay reasonable costs to expand or modify individual remote terminal locations.

42. The way the Act is supposed to work is that CLECs make requests and negotiate the terms and conditions with ILECs. Regulation serves as a backstop when agreement cannot be reached. It is apparent that ILECs have simply stonewalled reasonable CLEC requests, apparently in the hope that the Supreme Court would ultimately allow the ILECs to prevent the development of competition by charging excessive prices for UNEs. Now that the Supreme Court has ruled in favor of TELRIC, perhaps negotiations can move forward. CLECs can make requests and if the ILECs respond with reasonable cost showings, then CLECs may decide not to pursue certain

⁵¹ Joint Declaration of Tom Stumbaugh, David Reilly, and William Drake, Attachment F to Reply Comments of WorldCom, Inc., CC Docket No. 01-338, filed July 17, 2002, pp. 6-9.

deployment strategies. In the absence of reasonable responses to interconnection requests, CLECs have been forced to litigate rather than negotiate.

43. It must also be noted that the ILECs have a long history of making arguments about technical infeasibility and high compliance costs to oppose opening their markets to competition. The pre-divestiture Bell system argued that equipment and long distance competition were technically infeasible and that equal access was impossible to achieve. History demonstrates that their real motives were to protect their monopoly positions against feasible competition.

V. REGULATION IS A NECESSARY PREREQUISITE TO COMPETITION

44. The fifth theme in the ILEC comments is that regulation is bad *per se*. Most economists agree that regulation, including unbundling regulation, imposes costs. But this is where the ILEC analysis ends. Both economic theory and history show that once established in a network industry, monopoly endures. Affirmative government action is often necessary to allow normal market forces to proceed. The enhanced services, customer premises equipment and long distance markets are all good examples. In each case, interconnection, unbundling and equal access rules were required to establish competition. In each case, deregulation was made possible because of the regulation.

45. The ILECs and their economists make many claims about the need for regulation in this market. I agree with the ILEC economists who argue that regulation is unnecessary where there is no market power. However, as discussed in the HAI Report and in the paragraphs above, it is clear that the ILECs do have market power in the

⁵² An SBC witness in state proceedings admitted that his cost estimates were based on

provision of broadband services. Therefore, most of the ILEC analysis concerning the need for deregulation is irrelevant.

46. It is, of course, possible that the costs of regulation could exceed the benefits, even in the case where market power might be exercised. As I noted earlier, there is no question that regulation imposes costs. But the real issue is whether direct consumer benefits in the form of lower prices, or indirect consumer benefits in the form of reduced entry barriers for new market entrants made possible by the imposition of regulation, outweigh those costs.

A. Regulation Has Been Used to Facilitate the Introduction of Competition

47. Regulation has often been an essential tool for the introduction of competition. Regulation can be pro-competition in two ways. First, equal access and unbundling requirements can reduce entry barriers and result in a richer set of consumer options. Second, regulation can prevent incumbent firm predatory or strategic anticompetitive behavior designed to slow the growth of competitors.

48. The pre-divestiture Bell System was lightly regulated by the Commission prior to the introduction of competition in the long distance business. AT&T was not subject to explicit rate regulation until after it responded to the introduction of private microwave service with substantial price reductions for bulk private line services. The subsequent controversy lead the Commission to adopt, for the first time, significant tariff filing requirements and formal rate-of-return oversight on the interstate services of the

worst case scenarios. *See, e.g.,* IL Rehearing Transcript at 2189:14-18.

Bell System in an attempt to prevent discriminatory pricing.⁵³ The enforcement of these costing and pricing rules in fact prevented AT&T from implementing a number of discriminatory and anticompetitive tariffs.⁵⁴

49. Equal access requirements imposed by the MFJ and implemented by several procompetitive Commission actions were inherently regulatory in nature.⁵⁵ Yet competition would not have developed nearly as rapidly (or perhaps not at all) without them. As a result of this pro-competitive regulation, long distance competitors were able to attract capital and expand their networks. After Divestiture separated AT&T from the ILEC last-mile monopolies, the major source of its market power, the stage was set for the rapid growth of long distance competition and the ultimate deregulation of AT&T.

50. The Second Computer Inquiry provides another example of the use of regulation to stimulate competition. Customer premises equipment (“CPE”) competition was first allowed as a result of the Carterfone decision in 1968.⁵⁶ While some

⁵³ See *Nader v. FCC*, 520 F.2d 182, 191 (D.C. Cir. 1975). In summarizing FCC proceedings leading up to the Court’s decision to uphold an FCC ruling on an AT&T authorized rate of return, the Court states, “Docket 16258 [is the] [f]irst comprehensive investigation into the lawfulness of AT&T’s rates. Instituted December, 1965. 2 F.C.C.2d 142 (1965).” *Id.*

⁵⁴ A series of AT&T Private Line Tariffs were rejected in the 1970s. See OPP Working Paper No. 8, p. 54 for a discussion of the Hi-Lo tariff. This was one of a series of AT&T Tariffs responding in a discriminatory way to private line entry.

⁵⁵ See, *In the Matter of Investigation of Access and Divestiture Related Tariffs*, CC Docket No. 83-1145 Phase I, Memorandum Opinion and Order, 101 F.C.C. 2d 911 (1985), establishing regulations for *pro rata* allocation plan to assign non-presubscribed customers to interexchange carriers. See also, *In the Matter of MTS and WATS Market Structure*, CC Docket No. 78-72 Phase I, Memorandum Opinion and Order, 93 F.C.C.2d 241, 286-88 (1983), establishing premium charges for access service received by AT&T that was determined by the Commission to be technically superior to ENFIA A, B and C access received by non-AT&T interexchange carriers (ENFIA A, B and C access was later referred to as Feature Group A and B access following Divestiture).

⁵⁶ *Carterfone*, 13 F.C.C.2d 420 (1968), *recon. denied*, 14 F.C.C.2d 571 (1968).

competition for equipment purchased by large businesses developed as a result, the residential and small business market remained monopolized by local telephone companies. A significant reason was that the ILECs *bundled* equipment with service. A residential customer had the legal right to install her own telephone. However, the customer saved no money as a result because the Bell System telephone equipment was bundled with the service. The FCC ultimately ordered a credit to be applied to customers who supplied their own telephones, but the amount of the credit was insufficient to induce most consumers to give up their Bell System telephones. In the Second Computer Inquiry, the Commission required the complete *unbundling* of services and equipment.⁵⁷ The result was the development of a highly competitive residential telephone equipment business that would not have been possible without the regulatory requirement for unbundling.⁵⁸

51. The lesson to be taken from these historical examples is that regulation has been used effectively to introduce and stimulate competition, ultimately to the benefit of consumers. The pro-competitive framework of the 1996 Act followed these models by requiring the local analogues to unbundling and equal access.

⁵⁷ See *Amendment of Section 64.702 of the Commission's Rules and Regulations*, CC Docket No. 20828, Final Decision, 77 FCC 2d 384 (1980) (*Computer II Order*), para. 149, codified at 47 C.F.R. § 702(e).

⁵⁸ Not until 2001 did the Commission feel the CPE industry had developed sufficiently that the CPE bundling restriction could be eliminated. *Implementation of Section 254(g) of the Communications Act of 1934, as amended, 1998 Biennial Regulatory Review – Review of Customer Premises Equipment And Enhanced Services Unbundling Rules In the Interexchange, Exchange Access And Local Exchange Markets*, CC Docket Nos. 96-61, 98-183, Report and Order, 16 FCC Rcd 7418 (2001).

B. Competition Is Necessary for Deregulation

52. Until recent years, deregulation was focused primarily on eliminating regulations that were unnecessary to protect consumers from monopoly or that were affirmatively anticompetitive. For example, eliminating rules preventing or restricting competitive entry was the major focus of deregulation efforts in the 1970s.⁵⁹ In the 1980s, as competition became established due to the prior elimination of regulatory entry barriers and the implementation of pro-competitive resale, unbundling and equal access policies, the Commission began to focus on giving pricing flexibility to AT&T. In a series of decisions, AT&T was given increasing freedom to increase or lower prices. Tariff filing requirements were reduced and notice periods shortened, price caps were instituted, and eventually AT&T was declared non-dominant.⁶⁰ It is important to note that in the case of the long distance market, deregulation followed competition. It is also important to note that consumers have received enormous benefits from the long distance competition that has developed.

53. ILEC services have also been the subject of a great deal of deregulation. Most regulated ILEC services are subject to price caps instead of rate of return regulation,

⁵⁹ See generally proceedings in Docket 19528, the FCC customer premises equipment ("CPE") deregulation proceeding that in 1975 established regulations and a Registration Program allowing non-telco supplied CPE to be directly connected to the public switched telephone network; e.g., *Amendment of Part 68 of the Commission's Rules to Specify Standards for and Means of Connection of Telephone Equipment to Lamp and/or Annunciator Functions of Systems*, Memorandum Opinion and Order, Docket Nos. 19528, 20774, 21182, 70 FCC 2d 1800 (1979). See also, the Commission's Specialized Common Carrier decision which established rules permitting non-AT&T carriers to offer commercial interstate private-line transport services, *Specialized Common Carrier Services*, 29 F.C.C. 2d 870 (1971).

⁶⁰ *In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, FCC 95-427, Order, 11 FCC Rcd 3271 (1995).

resulting in substantial price and earnings flexibility. Tariff filing requirements have been all but eliminated and notice periods are quite short. Recent Commission orders have given ILECs both upward and downward pricing flexibility.

54. The results of ILEC deregulation have been quite different from the results of long distance regulation. ILEC profits have steadily increased. Commission data show that the interstate rate of return of price cap companies climbed steadily from 11.8 percent in 1991 to 19.5 percent in 2000.⁶¹ While ILEC returns may have fallen recently as a result of the recession, it must be remembered that many of their erstwhile competitors have gone bankrupt. In terms of pricing, as Ad Hoc reports, ILECs have used special access pricing flexibility to raise prices to many of their members.⁶² Another way to gauge the relative extent of competition is by comparing pricing performance in the monopoly local exchange business with pricing performance in the competitive long distance business. Inflation-adjusted long distance rates have fallen by approximately 80 percent since 1983, the year prior to Divestiture. ILEC local rates are essentially unchanged over the same period.⁶³

55. In sum, ILEC economists advocating further deregulation on theoretical grounds need to look at the empirical evidence. It is clear that much of the ILEC deregulation to date has not benefited consumers. There is no reason to believe that

⁶¹ FCC, "Trends in Telephone Service," Industry Analysis Division, Common Carrier Bureau, August 2001, Table 4-1.

⁶² *Broadband Dominance Proceeding*, Comments of Ad Hoc Telecommunications Users Committee, filed March 1, 2002 ("Ad Hoc Comments"), pp. 11-14.

⁶³ See, Declaration of Lee L. Selwyn, *In the Matter of Application by Verizon New Jersey, Inc., for Authorization to Provide In-Region, InterLATA Service in New Jersey*, CC Docket No. 01-347, February 28, 2002, p. 25.

further deregulation will bring benefits unless sufficient competition develops to curb their market power.

56. An unstated criticism of unbundling regulation is that it will fail because it is impossible to make the ILECs do what is not in their self-interest – *i.e.*, reduce barriers to entry into their markets by cooperating with CLECs through unbundling. The 1996 Act had a way to deal with this incentive incompatibility problem. The long distance carrot was supposed to induce the ILECs to cooperate. But as noted previously, it should by now be obvious to the Commission that you have to give the donkey the carrot *after* it moves. By allowing the Bell Operating Companies (“BOCs”) into the long distance market (and allowing mergers with conditions that the BOCs had no intention of honoring) without obtaining an enforceable commitment to compliance with the Act, the Commission has wasted opportunities. But unbundling can still be made to work as intended by Congress. Because of the ILEC litigation-induced delays in implementing unbundling, it is still early in the process. CPE unbundling and interconnection worked because a simple and enforceable interface was developed. Loop unbundling may yet prove to be susceptible to the same dynamic. Unresolved costing and pricing issues have suffered from Commission neglect. Reaffirmation of the goals of the Act and active enforcement of the tools provided by the Act are required, and can be used to overcome negative ILEC incentives.

C. CLECs Have Not Been Given Special Advantages

57. Haring and Shooshan claim that regulation has tilted the playing field in favor of the entrants:

Since the Telecommunications Act of 1996 was enacted, the government has been striving mightily to create competitors. It has done so by affording new entrants virtually every regulatory advantage they have sought, and has justified this tack as necessary to “jumpstart” competition during the transition to fully competitive (and presumably *less* regulated) markets.⁶⁴

This interpretation of recent history will also come as quite a surprise to CLEC investors. Regardless of the intent of policymakers, the ILECs have put every possible obstacle in the way of competition. CLECs have had to fight for even the most basic terms and conditions in order to purchase unbundled loops. Only in the past month, some six and a half years after the Act passed, have ILEC legal challenges to the Commission’s pricing methodology been put to rest.⁶⁵

58. The notion that competition and not the interests of individual competitors matters is, of course, absolutely correct. But as discussed at length here, and in the HAI Report, local markets are not competitive today and will not become competitive in the near term. Intramodal competition is important to give consumers the benefits of retail local exchange competition, to help preserve downstream competition in related markets, and to lower entry barriers.

59. Unbundling is necessary to implement intramodal competition. ILECs and ILEC economist criticisms of unbundling as a policy designed to protect individual competitors rather than promote competition are incorrect. Even SBC recognizes that there are situations in which competition needs a “jump start.” In criticizing the proposed

⁶⁴ Haring-Shooshan, pp. i-ii.

⁶⁵ Prior to the passage of the 1996 Act almost every economist agreed that when regulators set prices they should do so by reference to well-understood principles of economic cost. After the Act passed, a portion of the economics profession somehow lost sight of this basic principle.

decree in *U.S. v. Microsoft*, SBC is urging the Court to take steps to “pry open” the monopolized markets rather than waiting for the “next generation of emerging threats.”⁶⁶

VI. LOCAL SERVICE PRICING DOES NOT AFFECT AN IMPAIRMENT ANALYSIS

60. The U.S. Court of Appeals for the District of Columbia questions whether the presence of cross-subsidization may lead to differences in impairment across markets.⁶⁷ I do not believe that differences among state rate structures should affect an impairment analysis. First, as the court notes, cross-subsidization is often ordered “in the name of universal service.”⁶⁸ In the 1996 Act, Congress specifically recognized that such subsidies can harm the development of competition and provided that they should be made competitively neutral.⁶⁹ Instead of providing for universal service through internal rate structure manipulation (*i.e.*, implicit subsidies), subsidies should be funded by all market participants in a competitively neutral manner, including competitively neutral state universal service funding mechanisms.⁷⁰ The FCC has established the necessary

⁶⁶ SBC Comments, *U.S. v. Microsoft*, p. 10. *See also id.* p. 34.

⁶⁷ *USTA v. FCC*, 290 F.3d 415, 422 (D.C. Cir., 2002).

⁶⁸ *Id.*

⁶⁹ 47 U.S.C. §254(e). *See also Federal-State Joint Board on Universal Service*, CC Docket 96-262, Report and Order, 12 FCC Rcd 8776, (*Universal Service First Report and Order*), para. 9, “any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today.” (footnote omitted, quoting Joint Explanatory Statement of the Committee of the Conference (H.R. Rep. No. 458, 104th Cong., 2d Sess.) at 131).

⁷⁰ 47 U.S.C. §254(f) (“A State may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State.”).

fund to provide for interstate subsidies,⁷¹ and, while acknowledging its limited authority over state universal service funding mechanisms, recognizes that inevitably competitive marketplace forces created under the auspices of the 1996 Act will force states to establish similar explicit subsidies in their own intrastate funds.⁷² Many states have in fact undertaken this process.⁷³ As a consequence, universal service subsidies do not provide a basis for finding a lack of impairment.

61. Second, the vast majority of residential customers generate revenues above forward-looking costs (which provides the basis for a proper cross-subsidy test). The court's view that most local residential customers are the beneficiaries of large subsidies does not reflect recent trends. There has been substantial rebalancing of rates. The CALLS plan provided for increased subscriber line charges ("SLCs"), which has the effect of reducing subsidies from access charges.⁷⁴ At the same time, the demand for features such as voice mail and call waiting has increased substantially in recent years. The access revenue generated by residential subscriber intrastate and interstate calls also must be included in the revenues received by local exchange carriers.

⁷¹ *Universal Service, First Report and Order*, para. 20.

⁷² *Id.*, para. 14 ("We [FCC] further believe that, as competition develops, the marketplace itself will identify intrastate implicit universal service support, and that states will be compelled by those marketplace forces to move that support to explicit, sustainable mechanisms consistent with section 254(f).").

⁷³ *See, e.g.*, State of California, Public Utilities Commission, "Universal Service Report to the Governor and the Legislature," December 1, 1999.

⁷⁴ *In the Matter of Access Charge Reform*, CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, *Low-Volume Long-Distance Users*, CC Docket No. 99-249, and *Federal-State Joint Board On Universal Service*, CC Docket No. 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, and Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) ("*CALLS Order*").

62. I compared local revenues to the costs estimated by the Commission's HCPM Model. The FCC's year 2000 rate survey provides residential rates in the 95 markets for which the Commission collects local rate data.⁷⁵ The residential SLC as well as average feature revenues must be added to these rates.⁷⁶ The revenue generated by customers can then be compared with forward-looking costs.

63. I estimate an average local rate for the 95 cities of \$18.70, and assume \$8.00 per line of feature and access revenue, for a total of \$26.70.⁷⁷ The FCC's HCPM Model generates an average cost per line of \$20.33 for the cities in the rate survey.⁷⁸ Feature costs are included in the switching cost estimates of the cost model. Thus, on average, local service is not subsidized. In looking at the individual cities, I find that only eight smaller markets included in the FCC survey are subsidized. All or portions of these eight markets may well be eligible for federal or state explicit universal service subsidies. If the lower cost estimates generated by the HAI Model are used in this analysis in place of

⁷⁵ Year 2000 raw rate data can be found at <http://www.fcc.gov/web/iatd/lec.html>. I did not include taxes in the revenue calculation.

⁷⁶ The current weighted average SLC is \$5.08. I estimated average per line feature and access revenues at \$4.00 each.

⁷⁷ The ILECs do not report feature revenue. However, the eight-dollar figure appears to be conservative. The FCC reports that in 2000 the average monthly household payment to local exchange carriers was \$35, which is substantially higher than the average rate for unlimited service alone. Features are high margin services. In addition, households paid long distance carriers an additional \$18, a significant portion of which represents access charges ultimately received by local carriers, which also will contribute to the net revenue generated by local customers. *See Trends in Telephone Service*, May 2002, Table 3.2.

⁷⁸ HCPM results were derived for wire centers located in the cities identified in the rate survey sample. Due to HCPM data limitations, I was unable to compute costs for four of the 95 markets in the FCC rate survey.

the HCPM results, in most cities local revenues cover local costs even without accounting for feature and access revenue.⁷⁹

64. It would be incorrect to suggest that because business revenues are far in excess of costs, CLECs are not impaired in competing for customers despite their higher costs. First, as shown in the analysis of Dr. Bryant accompanying WorldCom's Reply Comments, the CLEC cost disadvantage is substantial.⁸⁰ Second, the ILECs have the ability to strategically reduce prices in response to competition. CLECs will not sink substantial amounts in facilities that they would not be able to efficiently compete with if prices were driven towards cost.

⁷⁹ In my opinion, the HAI results are closer to a true TELRIC than the results from the FCC Model.

⁸⁰ Bryant Declaration, *supra*. note 12.

Declaration

I declare under penalty of perjury that the foregoing is true and correct.

Executed on July 16, 2002.


A. Daniel Kelley

Attachment C

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Section 251 Unbundling)	
Obligations of Incumbent Local Exchange)	CC Docket No. 01-338
Carriers)	
)	
Implementation of the Local Competition)	
Provisions of the Telecommunications Act)	CC Docket No. 96-98
of 1996)	
)	
Deployment of Wireline Services Offering)	CC Docket No. 98-147
Advanced Telecommunications)	
Capability)	

**DECLARATION OF WAYNE HUYARD
On Behalf of WorldCom, Inc.**

1. My name is Wayne Huyard. I am the Chief Operating Officer of MCI. In this Declaration, I will focus on MCI's recent introduction of its Neighborhood calling plan and the benefits it will bring to consumers. Those benefits add to those consumers are already receiving through MCI's extant local service.
2. The information set forth herein is based either on my personal knowledge or upon information provided to me by those responsible for assisting me in performing my duties at MCI.
3. Since 1998, MCI has been bringing competitive local service to residential customer in major markets across the country. MCI first introduced local competition to New York in 1998, and by February of 2002 had expanded into a total of 11 states: New

York, Texas, Pennsylvania, Illinois, Michigan, Georgia, Florida, California, Ohio, Indiana, and Wisconsin.

4. By entering into the local market place, MCI has changed the way consumers view local service, and customers are realizing the benefits of choice and value. MCI's forward-thinking products are responsible for bringing unlimited local calling to the New York market, for example, and delivering the first truly bundled product of local, long distance, and features. In New York, after four years in the local market, MCI has reached a 7% market share.

5. MCI has changed the local marketplace, and now MCI looks to revolutionize telephone service altogether. On April 15, 2002, MCI introduced the Neighborhood, a ground-breaking new business designed to unite historically separate local and long-distance services. The Neighborhood establishes a new all-distance communications category. With Neighborhood Complete, consumers will, for the first time, be able to combine their local and long distance calling services into one integrated package at one fixed monthly price. MCI has introduced the Neighborhood in select areas in 34 states with availability in all remaining states expected by 2003. The Neighborhood is already available to over 54 million households.

6. Consumers have a variety of product options within the Neighborhood. MCI's flagship product is Neighborhood Complete, the first and only nationwide service to free callers from the constraints of per minute rates, time of day restrictions, and unnecessary boundaries between local and long-distance service. Consumers who select Neighborhood Complete will experience the convenience of a single company and a single invoice for all home phone service

7. For just \$49.99 to \$59.99 per month, depending on the state,¹ Neighborhood Complete provides all-inclusive, any-distance home phone service, including all local, local toll, in-state and state-to-state calling along with Caller ID, Call Waiting, Voicemail with pager and/or e-mail notification, Three-Way Calling, Anonymous Call Rejection and Speed Dial. All residential domestic calls are free, whether previously defined as local or long distance, in-state or interstate, any day, any time. The entire U.S. effectively becomes one local calling area and the entire country becomes one neighborhood.

8. Neighborhood Complete offers simple, universal benefits that every consumer can understand and appreciate. It delivers the freedom to speak for free. The customer no longer has to worry about whether a call is local, intraLATA, or interLATA. All essential calling features are included. The customer no longer has to watch the clock and count pennies for each minute that passes by on long distance calls. The customer can budget his monthly phone bill just like other fixed monthly bills. And the customer receives a single bill for all phone service with a single place to call for any customer service issues.

10. The Neighborhood Complete is also less expensive than would be ordering a comparable bundle of services from a BOC. A customer who ordered Verizon's unlimited local product with a similar feature package, for example, would pay an amount almost identical to that paid by a customer who ordered the Neighborhood – *but would still have to pay for all long distance usage*. Thus, a Verizon customer with an

¹ The price varies because the costs vary.

average amount of long distance service would pay \$13.56 more per month than would a Neighborhood customer.

11. In addition to Neighborhood Complete, MCI offers Neighborhood Choice and Neighborhood Standard. Neighborhood Choice is priced at \$25.99-\$37.99 per month depending on the state. The key differences from Neighborhood Complete are that long distance calls to customers who are not MCI local customers cost 7 cents per minute and voicemail costs 6 dollars per month. Neighborhood Choice is available in about two-thirds of the states where MCI currently provides local service. Neighborhood Standard is priced at \$12.99-\$28.99. The key differences from Neighborhood Complete is that long distance calls to customers who are not MCI local customers cost 12 cents per minute, features are not included, and voicemail costs 6 dollars per month.

Neighborhood Standard is available in only a few states. Neighborhood Standard is the only Neighborhood product that is not a high end product.

12. MCI has also begun offering a product similar to the Neighborhood for small business customers. Small business customers generally have similar telecommunications needs to consumers. WorldCom's research shows that 90% of small business customers with 12 lines or less have POTS lines. At present, 80% of small business customers remain with the ILEC, yet CLECs are precluded from serving many of these customers via UNE-P because of the FCC's 3-line exception for unbundled switching. However, four states – Illinois, Texas, New York and Pennsylvania allow use of unbundled switching for customers with more than three lines. Thirty two percent of the lines WorldCom has sold to date for its Business Complete product have been to customers in these states who have more than 3 lines.

13. For \$39.99-\$49.99 for a primary line, depending on the state, and substantially less for additional lines, Business Complete includes either unlimited local calling or a generous 3000-minute allowance per line (and 2¢ per minute over the allowance), depending on the state. Charges are no longer based on time of day, distance of the call, and whether the call is in its first minute or additional minutes – as is the case for ILEC customers in some states. In addition, MCI typically includes extended local calling areas as part of its product. Call Waiting, Caller ID, Call Forwarding, Speed Dial, 3-Way Calling and hunting/rollover are included for no extra charge. Long distance calls cost a flat 6.9¢ per minute for all domestic calls no matter the time of day or day of the week. Additional lines cost only \$24.99-\$34.99 per month.

14. As of June 21, WorldCom was offering Business Complete in 18 states and plans to be providing service in 36 states by September 2002. On average, WorldCom is serving 80% of the LEC territory in the states it has entered.

15. At present, the Neighborhood is a voice product only – it is not designed for dial-up Internet access. This distinction is necessary because most states have set switching prices on a per minute of use basis, and it is not thus not economically feasible to offer the product to customers who wish to remain on-line 24-hours per day. If more states set switching costs on a flat (*i.e.*, non-per-minute) basis, description of these products as “voice” products may change.

16. We are actively working to expand the Neighborhood product offering to include broadband access. Specifically, we would like to combine our voice offering with WorldCom’s DSL products and engage in line splitting. Unfortunately, as Ian Graham has explained, the ILECs have not developed sufficient processes to enable us to engage

in line splitting.² We have convened an internal “line splitting task force” to resolve all issues associated with line splitting, including resolution of key scenarios involved with migrating and adding voice and data to a customer’s line.

17. Along those lines, a significant issue that is limiting our ability to serve thousands of consumers is the ILECs’ refusal to continue providing their DSL service to end users who wish to migrate their voice service to MCI. This anticompetitive practice is constraining our ability to compete because we are unable to serve any end-user who has ILEC-DSL service. We recently filed a complaint with the Georgia Public Service Commission and we expect to follow-up with similar complaints in other states.

18. The Neighborhood is a revolutionary new product, a compelling new brand and a new MCI mission. Over the past few years, it has become absolutely clear that customers desire a bundled product for local and long distance. Research shows that the vast majority of consumers prefer a single carrier for local and long distance, and more than 80% of MCI’s new customers in areas where we have offered local service choose us for both local and long distance. In New York, the first state where consumers were given a legitimate choice for local service and where Verizon entered long distance over two years ago, more than half of households now have the same carrier for both local and long distance, and nearly 90% of consumers who have chosen to switch either their local or long distance provider have chosen to consolidate with a single company.

19. The Neighborhood takes the advantages of a bundled service offering one step further. The Neighborhood is the communications industry's first large scale, credible threat to the local phone monopolies' lock on the consumer calling market because it is

² Graham Declaration at ¶ 15 (Attachment C to WorldCom’s initial Comments).

the only enterprise to truly offer a fully integrated service across the country. With the launch of The Neighborhood, MCI is the first communications company to truly fulfill the vision of the "any-distance" future outlined by the Telecommunications Act of 1996.

20. The success of the Neighborhood, of course, depends on the continued availability of the unbundled network elements platform at TELRIC prices. High loop and switching prices preclude MCI from offering the Neighborhood ubiquitously, force MCI to charge more for the Neighborhood in some states, and limit the availability of the Neighborhood to certain zones within states. Moreover, MCI remains dependent on BOC OSS.

21. But the key to the success of the Neighborhood is the continued availability of UNE-P. The fact is that there is no economic case to support facilities construction in the residential or small business market at the present time or in the near future, and any decision to limit or discontinue UNE-P would effectively kill competition in those markets.

22. In order to compete effectively for mass markets customers, CLECs must be able to construct broad marketing operations and to quickly and efficiently migrate customers. At present, they cannot do so with an unbundled loops strategy nor with a combination of unbundled loops for some customers and UNE-P for others. Because of today's manual hot cut process, ILECs are incapable of quickly processing mass volumes of UNE-L orders. Moreover, the cost of the hot cuts and the cost of collocation are simply too high to make a UNE-L strategy successful. Even where WorldCom has already collocated to serve large business customers, it has determined not to use a UNE-L strategy to serve residential and small business customers. In part, this is because of the difficulty of


combining a UNE-P and a UNE-L strategy in one operation, which would require construction of sophisticated means of differentiating UNE-P and UNE-L orders. In part, it is because of the cost and difficulty of the hot cut process, a process that many mass markets customers are not willing to tolerate. And in part it is because at many of the central offices at which WorldCom is already collocated, WorldCom would have to rent additional space to begin serving analog customers, as all of its current space is devoted to serving digital customers. WorldCom would also have to pay to install analog equipment at each collocation. When these factors are combined, it is clear that a UNE-L strategy is an impossibility at present.

23. The Telecommunications Act has only begun to work in the residential and small business market. The Neighborhood is a clear example of how it can work. Instead of killing competition for local service – and, at the same time, severely harming competition for long distance service, the FCC and the states should focus on forcing UNE pricing to cost so more of America can be served and so more products can be made available.

Declaration

I declare under penalty of perjury that the foregoing is true and correct.

Executed on July 16, 2002.



Wayne Huyard